Sheryl (Sherry) L. Herauf
Director
Federal Regulatory Relations

1275 Pennsylvania Avenue, N.W., Suite 400
Washington, D.C. 20004
(202) 383-6424

PACIFIC TELESIS
Group - Washington

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

January 10, 1994

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 93-251 Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "*Reply Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Sherry Herauf

Enclosures

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	CC Docket No. 93-251

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

JAMES P. TUTHILL
LUCILLE M. MATES

140 New Montgomery St., Rm. 1526
San Francisco, California 94105
(415) 542-7654

JAMES L. WURTZ

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-6472

Attorneys for Pacific Bell
and Nevada Bell

Date: January 10, 1994

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SUMMARY

Pacific Bell and Nevada Bell, and the majority of commentors to this NPRM, do not support the increased regulation proposed by this proceeding. The Commission has not justified the need for additional regulation of affiliate transactions in view of increasing competition and the Administration's directive to decrease government regulation. Moreover, price cap regulation has reduced carriers' incentives to cross subsidize and provides incentives to reduce expenses.

We strongly oppose requiring fair market value studies for services provided between affiliates. Significant resources will be needed to determine the market value of the many services provided between affiliates. Moreover, market value will not be ascertainable if a service is not available from third parties. Because market studies are more subjective than fully distributed cost ("FDC") rules and thus less easily verifiable, costs based on market value will be less reliable and will likely engender additional Commission attention and resources. Coopers & Lybrand in fact suggests that requiring a comparison between fair market value and FDC will have the effect of diminishing the current enforcement mechanism. If, however, the Commission requires a market value comparison, market value studies should only be required for services whose annual billings exceed $250,000.

The Commission should not establish a bright line test to define an affiliate that would be able to value its sales to carriers by its prevailing price. Any bright line will be an arbitrary percentage. Instead the circumstances of the affiliate

and the transaction should be considered in the determination of the number of "significant" nonaffiliate transactions. As recommended by USTA, the Commission should rely on existing safeguards which have been effective. If, however, a bright line test is adopted, we recommend applying the test on a total company basis.

Contrary to MCI's claim, ratepayers are not damaged if carriers charge fully distributed costs that are below market value. If a carrier recovers FDC, there will be no underrecovery or overrecovery to influence rates in the future in the price cap mechanism. On the other hand, requiring that the higher market value be charged would result in nonregulated activities subsidizing ratepayers. The Commission has previously rejected the use of cost allocation rules to subsidize regulated services and should continue to do so now.

The Commission should also reject the recommendation to require affiliate charges to be identified in accordance with the Part 32 expense matrix which would only significantly increase the cost of affiliate transactions with no ratepayer benefit. Similarly, the recommendation that a carrier's cost allocation manual list each tariff that governs the transfer of tariffed services should be rejected. This additional detail will increase a carrier's administrative burden without offsetting benefit.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	CC Docket No. 93-251

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell respectfully reply to the comments submitted to the Notice of Proposed Rule Making, released October 20, 1993 in the above-captioned docket ("NPRM"). Pacific Bell and Nevada Bell[1] and other local exchange companies ("LECs") generally oppose the proposed rules that result in a significant increase in the regulation of affiliate transactions. Only two state public utilities commissions, two industry associations and MCI commented in support of the proposed rules.[2]

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1 Comments of Pacific Bell and Nevada Bell, dated December 10, 1993, ("Comments").

2 Comments of the Tennessee Public Service Commission Staff, ("Tennessee"); Comments of the Public Utility Commission of Texas, dated December 1, 1993 ("Texas"); Comments of the Information Technology Association of America, dated December 10, 1993 ("ITAA"); Comments of the International Communications Association, dated December 10, 1993, ("ICA"); Comments of MCI Telecommunications Corporation, dated December 10, 1993 ("MCI").

I. INTRODUCTION

In our Comments, Pacific Bell and Nevada Bell objected to the additional regulation of affiliate transactions as unnecessary and unjustified. In the current business and regulatory environment, carriers have no incentive to cross-subsidize their affiliates. There is no question that LECs are increasingly subject to competition.[3] As the Commission has long advocated, government regulation should yield to marketplace forces where there is competition. And, both the Commission and the current Administration recognize the need to minimize government when possible.

Moreover, price cap regulation, as intended by the Commission, further reduces any incentive to cross-subsidize. As the Commission explained

> [B]ecause price cap regulation severs the direct link between regulated costs and prices, a carrier is not able automatically to recoup misallocated non-regulated costs by raising basic services rates, thus reducing the incentive for BOCs to shift non-regulated costs to regulated services.[4]

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3 MCI recently announced plans to build fiber rings in 20 major cities to permit it to bypass LECs' access service and offer its own local exchange services. John J. Keller, MCI Proposes a $20 Billion Capital Project, WALL ST. J., Jan. 5, 1994, at A3.

4 Computer III Remand Proceedings: Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, CC Docket NO. 90-623, Report and Order, 6 FCC Rcd 7571 (1991) at para. 55.

In addition, price cap regulation provides carriers with an incentive to reduce, not raise, expenses so as to meet their productivity goals.[5]

The proposed rules would significantly increase the extent of regulation of affiliate transactions. The need for increased regulation is not justified by the NPRM. General statements of the Commission's "experiences" are insufficient to explain why further safeguards are required to protect ratepayers and why the particular rules proposed are appropriate. We agree with ICA's recommendation that the Commission should provide more detail and citations to support the conclusions which led to the proposed rules.[6] As issued, the NPRM lacks any evidence to support or justify the additional burdensome rules proposed.

II. APPLYING THE ASSET VALUATION RULE TO SERVICES IS NOT IN THE PUBLIC INTEREST.

The Commission's current asset valuation rule requires that an asset transferred from (or to) regulation must be valued at the higher (or lower) of fair market value or net book cost.[7] However, the current valuation rule for services transferred between a carrier and its affiliate requires a

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[5] On the other hand, the rules proposed by this proceeding increase the level of regulation, increase the cost of affiliate transactions, and can thus ultimately negatively affect a price cap carrier's productivity measurement.

[6] ICA at p. 5.

[7] 47 U.S.C. §32.27 (b)&(c).

service to be valued at fully distributed costs in the absence of a tariffed price or a prevailing price.[8] The rule change proposes to adopt valuation rules for services similar to that for transferred assets: services would be valued at the higher (or lower, if an affiliate provides services to a carrier) of fair market value or fully distributed costs.

Pacific Bell, Nevada Bell and other LECs strongly oppose this rule change. As the comments to the NPRM show, the requirement to determine the fair market value of services will create administrative burdens that are not justified by offsetting benefit.

Determining a fair market value is a costly endeavor. Pacific Bell has direct experience with providing market valuation for transactions with affiliates. The California Public Utilities Commission ("CPUC") requires Pacific Bell to perform market price studies for each non-tariffed good or service whose annual aggregate billing provided to non-Bell affiliates exceeds $100,000. Since January, 1992 Pacific Bell has undertaken market price studies for 11 services. Pacific Bell has historically hired an independent consultant to perform these studies. To date, the average cost of the studies has been

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8 Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities, CC Docket No. 86-111, 104 FCC 2d 59 (1986) ("NPRM"), 2 FCC Rcd 1298 (1987) ("Report and Order"); on recon., 2 FCC Rcd 6283 (1987) ("Recon. Order"); on further recon., 3 FCC Rcd 6701 (1988); aff'd sub nom. Southwestern Bell Corp. v. FCC, 896 F.2d 1378 (D.C. Cir. 1990).

approximately $40,000.[9] Pacific Bell's cost allocation manual ("CAM") currently lists approximately 100 different services provided to its nonregulated affiliates. If required, fair market valuation studies for these 100 services would amount to $4 million dollars. That cost is not justifiable, especially when the fully distributed cost of more than 50% of the services will not exceed $40,000 in annual billings.

Even if the Commission does not require formal fair market studies, the burden of undertaking informal methods of determining fair market value outweighs any potential benefit of requiring a comparison between fair market value and fully distributed costs. The sheer number of services which would be subject to fair market study makes the requirement burdensome. The fair market study rule works satisfactorily for assets because, as anticipated, there have been few asset transfers.[10] In contrast, the large number of services transferred will require significant resources.

Moreover, the fair market value of some services may not be determinable if an equivalent service is not available from third parties. An example of this is the fair market value of corporate governance functions which a holding company

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9 That amount is comparable to that reported by NYNEX. Comments of the NYNEX Telephone Companies, dated December 10, 1993, at p. 19.

10 Recon. Order at para. 118; Comments of Coopers & Lybrand, dated December 9, 1993, ("C&L") at p. 3.

affiliate, as the corporate parent, can be expected to provide to the corporation as a whole, including a carrier.

As the Commission recognized,[11] fully distributed cost is a better basis for determining the cost of services between affiliates. Fair market value is less verifiable than fully distributed costs. C&L discusses the inherent subjectivity of fair market value estimates.[12] The complexities and subjective judgment required to adjust comparisons because comparable transactions are not identical to the subject transaction can result in significant opposition and wrangling that will take limited Commission and carrier resources to resolve. For price cap carriers, the cost of the studies and the attendant legal/regulatory efforts will result in decreased productivity and efficiency when market forces demand greater productivity and efficiency.

Fully distributed costs are also more reliable because the rules to determine such costs are well established. Carriers have had 6 years of experience with the rules. Compliance by carriers with those rules is also auditable. C&L points out that requiring a comparison between market value and fully distributed cost will add complexity and subjectivity to the audit process with the effect of diminishing the enforcement mechanism the FCC currently has in place.[13] Increasing the

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11 Recon. Order at para. 130.

12 C&L at p. 3.

13 Id. at p. 1.

complexity of the audit process is not in the public interest. Neither the Commission nor LECs have an abundance of resources with which to deal with additional complexity.

Moreover, if the Commission reverses its policy and regulation, it must do so with rational and explicit explanation that will permit judicial review.[14] That has not occurred. The Commission has not explained why fair market value, a method which it previously rejected as being subject to manipulation, is now preferred. The Commission must provide a thorough and comprehensible statement of the reasons for the decision.[15]

Commentors in favor of adopting the asset transfer rules for service transactions do not provide evidence to counter the objections raised by LECs to the proposed rule. We urge the Commission to reject the proposal to require a comparison between fair market value and fully distributed costs to value services transferred between a carrier and its affiliate. Services should continue to be valued at fully distributed costs in the absence of tariffed or prevailing price. However, if the Commission adopts the proposal and fair market value studies are required, the Commission should only require studies for services whose annual billings exceed $250,000. This threshold will eliminate from the requirement many services for which the cost of a market study could potentially exceed the value of the service being

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14 Office of Communications of the United Church of Christ v. FCC, 560 F.2d 529, 532 (1977).

15 5 U.S.C. §553(c).

provided. Moreover, the Commission should adopt a policy such as that of the CPUC, which only requires a new study to be conducted four years after the date of the original study. During the interim period, studies are updated by the Consumer Price Index. If the Commission requires fair market valuations, studies should be required only every four years or less frequently.

III. A BRIGHT LINE TEST WILL NOT CONSIDER APPLICABLE INDIVIDUAL CIRCUMSTANCES.

The NPRM proposes a "bright line test" to determine when an affiliate has the predominate purpose of serving other affiliates. If an affiliate is primarily intended to serve nonaffiliates, the affiliate's prevailing price can be used to value its services provided to a carrier. However, the prevailing price of an affiliate primarily intended to serve its affiliates is not considered to be an accurate representation of the market and could be an inflated price.

Pacific Bell and Nevada Bell support the position asserted by USTA.[16] The Commission should not establish an arbitrary amount to define what is "substantial" so as to qualify an affiliate to charge its prevailing price to its affiliated carrier. A bright line test will always be arbitrary. A fixed percentage of output cannot be a reasonable test in all circumstances. Instead, the circumstances of the affiliate and

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16 Comments of the United States Telephone Association, dated December 10, 1993 ("USTA") at pp. 18-20.

the transaction should be considered. The amount of business that one company does may be reasonable to establish a "significant amount" in light of its circumstances but unreasonable in different circumstances. The Commission should rely on existing safeguards, as recommended by USTA.

The Commission should also note the effect of choosing a high threshold to qualify an affiliate to use prevailing prices. The higher the threshold, the more likely that a greater number of service transactions will have to be valued using fair market value. Thus, more services will be evaluated using fair market valuation which is less objective and verifiable than a prevailing price.

If a bright line test is adopted, the test should not be applied to each product. Even MCI recognized the incredible burden that would impose.[17] Instead, the bright line test should apply on a total company basis.

IV. RATEPAYERS ARE NOT DAMAGED IF LECS PROVIDE SERVICES FOR LESS THAN FAIR MARKET VALUE.

In our Comments, Pacific Bell and Nevada Bell explained how ratepayers can benefit from the sale of services at fully distributed costs but below fair market value. MCI, on the other hand, argues that if a LEC sells services at less than fair market value, ratepayers are damaged twice.[18] MCI is wrong.

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17 MCI at p. 14.

18 MCI at p. 7.

MCI does not explain how services sold to affiliates for less than fair market value will lead to discriminatorily inflated prices. If a carrier recovers at least fully distributed costs, the costs are fully recovered and there will be no underrecovery or overrecovery to influence rates in the future in the price cap mechanism. Thus, fully distributed costs do not impact rates. The ratepayer is not paying more or less because of an affiliate transaction if the full cost of the service is recovered. Without an impact on rates, the possibility of cross-subsidy at the expense of the ratepayer does not exist.

On the other hand, if a carrier is required to charge the affiliate fair market value when that value is greater than fully distributed costs, the difference essentially becomes a subsidy from the shareowner to the ratepayer. The affiliate transaction rules were never intended to result in such reverse subsidization. In the original Docket 86-111 proceeding, the Commission rejected any attempt to arrange a subsidy for regulated activities through the cost allocation rules.[19]

MCI is also wrong that charging fully distributed costs will permit carriers to "exploit" the sharing mechanism.[20] As discussed above, recovery of fully distributed costs precludes underrecovery or overrecovery of costs. However, by its allegation, MCI appears to advocate that more than cost should be

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[19] Report and Order at para. 109.

[20] MCI at p. 7.

recovered from affiliates -- that LECs should be required to charge a "profit" greater than the allowable rate of return (which is included in the fully distributed cost but which is exceeded in a higher fair market value). MCI suggests that the higher revenue can raise the LEC's overall earnings, thus increasing the likelihood of or the amount available for sharing. But, because the Commission has previously rejected the notion of using cost allocation rules to subsidize regulated services, MCI's allegation is completely without merit.

V. THE COMMISSION SHOULD REJECT FURTHER RECOMMENDATIONS MADE IN COMMENTS.

A. Applying the Part 32 expense matrix to affiliate bills provides no benefit to ratepayers.

The Tennessee Public Service Commission Staff recommends that affiliates follow Part 32 accounting procedures to identify costs billed to regulated carriers in accordance with the Part 32 expense matrix.[21] This will permit the Tennessee Commission to continue to compare matrix information provided by carriers prior to organizational changes with post-reorganizational information.

The Commission should reject this recommendation for several reasons. First, the Commission only has jurisdiction over regulated affiliates. Secondly, implementing the expense matrix for affiliate bills would add to the cost of the service, increasing either the affiliate's cost (if the affiliate

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21 Tennessee at p. 7.

voluntarily adopted Part 32, the Uniform System of Accounts, including the expense matrix system) or the carrier's cost in getting the service (if the carrier converted the affiliate's bill to the expense matrix). In either case, the cost would be particularly unjustified where the carrier constitutes a small part of the affiliate's business.

More importantly, however, there is no benefit to ratepayers from requiring the additional burden of the matrix format for affiliates' bills. The format does not reduce the billed amount or the accounting of the costs. Finally, there is no reason to require a costly change from all LECs because of circumstances unique to one state. The Tennessee Commission can establish such a rule if it believes it is in the the best interest of its state ratepayers.

B. Requiring a CAM to list each section and subsection of a tariff on file is unnecessary.

ICA proposes that the Commission require each carrier to list in its CAM each section and subsection of a tariff on file that governs its services transferred.[22] The Commission should reject that recommendation as unnecessary detail that will merely add to the administrative burden of affiliate transactions. Tariffs are on file with the Commission. The tariff under which a service is provided is thus easily verifiable. The Commission should continue to resist efforts to add more and more detail to

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22 ICA at p. 10.

the CAM, especially when there is little or no offsetting benefit from the additional administrative burden.

VI. CONCLUSION

The record evidence provided by the comments clearly calls into question the need for any increase in the level of regulation and for the rule changes proposed. In addition to the lack of evidence that any additional regulation is needed, the significant administrative cost to both the Commission and to carriers to implement and monitor the proposed changes would far exceed any value that would be gained by the increased regulation. Absent compelling reasons to justify the reversal of the Commission's evaluation of the adequacy of current safeguards, the existing level of ratepayer protection and established rules, such as using fully distributed costs to determine the value of services, should be maintained.

Respectfully submitted,

PACIFIC BELL
NEVADA BELL

Lucille M. Mates

JAMES P. TUTHILL
LUCILLE M. MATES

140 New Montgomery St., Rm. 1526
San Francisco, California 94105
(415) 542-7654

JAMES L. WURTZ

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-6472

Their Attorneys

Date: January 10, 1994

<u>CERTIFICATE OF SERVICE</u>

I, Agnes M. Lowe, hereby certify that a copy of the foregoing Reply Comments of Pacific Bell and Nevada Bell in the Matter of CC Docket No. 93-251 was served upon each of the parties listed on the attached service list, on this 10th day of January, 1994, by first class United States mail, postage prepaid, or by hand delivery.

Agnes M. Lowe

Agnes M. Lowe

Service List
CC Docket No. 93-251

John T. Lenahan
Barbara J. Kern
Attorneys for Ameritech
2000 West Ameritech Center Drive
Room 4H88
Hoffman Estates, IL 60196-1025

Francine J. Berry
Robert J. McKee
Judy Sello
Attorneys for AT&T
295 North Maple Ave., Rm 3244J1
Basking Ridge, NJ 07920

Lawrence W. Katz
David K. Hall
Attorneys for Bell Atlantic
Telephone Companies
1710 H Street, N.W.
Washington, DC 20006

M. Robert Sutherland, Attorney
BellSouth Telecommunications, Inc.
4300 Southern Bell Center
675 West Peachtree Street, N.E.
Atlanta, Georgia 30375

William D. Baskett III
John K. Rose
FROST & JACOBS
Attorneys for Cincinnati Bell
Telephone Company
2500 PNC Center
201 East Fifth Street
Cincinnati, Ohio 45202

John W. Putnam, Partner
Coopers & Lybrand
370 Seventeenth St., Suite 3300
Denver, CO 80202-5633

Gail L. Polivy, Attorney
GTE Service Corporation
1850 M Street, N.W., Suite 1200
Washington, DC 20036

Joseph P. Markoski
Kerry E. Murray
Squire, Sanders & Dempsey
Attorneys for The Information
Technology Association of America
1201 Pennsylvania Ave., N.W.
P.O. Box 407
Washington, DC 20044

Brian R. Moir, Esquire
Attorney for the International
Communications Association
1255 23rd St., N.W., Suite 800
Washington, DC 20037-1170

Elizabeth Dickerson
Manager, Federal Regulatory
MCI Telecommunications Corporation
1801 Pennsylvania Ave., N.W.
Washington, DC 20006

David Cosson, Attorney
National Telephone Cooperative Assn
2626 Pennsylvania Ave., N.W.
Washington, DC 20037

Mary McDermott
Campbell L. Ayling
Attorneys for NYNEX Telephone Cos.
120 Bloomingdale Road
White Plains, NY 10605

Joe D. Edge
Elizabeth A. Marshall
Hopkins & Sutter
Counsel for Puerto Rico Telephone Co.
888 Sixteenth Street, N.W.
Washington, DC 20006

Anne U. MacClintock, Vice President
Regulatory Affairs & Public Policy
Southern New England Telephone Co.
227 Church Street
New Haven, Connecticut 06510

Diane Harter
Durward D. Dupre
Richard C. Hartgrove
Jeanne A. Fischer
Attorneys for Southwestern Bell
Telephone Company
1010 Pine Street, Room 2114
St. Louis, Missouri 63101

Jay C. Keithley, Attorney
Sprint Corporation
1850 M Street, N.W., Suite 1100
Washington, D.C. 20036

Archie Hickerson, Deputy Director
Tennessee Public Service Commission
480 James Robertson Parkway
Nashville, Tennessee 37243-0505

Carolyn C. Hill
Federal Regulatory Counsel
ALLTEL Service Corporation
655 15th St., N.W., Suite 220
Washington, DC 20005

Robert W. Gee, Chairman
Karl R. Rabago, Commissioner
Sarah Goodfriend, Commissioner
Public Utility Commission of Texas
7800 Shoal Creek Boulevard
Austin, Texas 78757

Martin T. McCue, VP & Gen. Counsel
Linda Kent, Assoc. Gen. Counsel
United States Telephone Association
1401 H Street, N.W., Suite 600
Washington, DC 20005-2136

Donald M. Mukai, Attorney
U S West, Inc.
1020 19th Street, N.W., Suite 700
Washington, DC 20036

*William A. Kehoe, III
Accounting and Audits Division
2000 L Street, N.W.
Washington, DC 20554

*ITS, Inc.
1919 M Street, N.W., Room 246
Washington, DC 20554

*Hand-delivered

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